Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling

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Abstract

A series of financial scandals, climaxing in the 2002 bankruptcy of the Enron Corporation, revealed a key weakness in the American business model: the failure of the U.S. auditing system to deliver true independence. We offer a two-tiered analysis of what went wrong. At the more micro tier, we advance moral-seduction theory which explains why professionals are often unaware of how morally compromised they have become by conflicts of interest. At the more macro tier, we offer issue-cycle theory which explains why conflicts of interest of the sort that compromised major accounting firms are so pervasive. The latter theory depicts organizations as norm creators (not just followers) that: (a) relentlessly seek out rent-seeking opportunities under rhetorical smokescreens designed to create attributional ambiguity about their intentions; (b) retreat only under intense pressure, such as that created when conflicts of interest lead to significant losses among important political constituencies; and (c) as soon as outrage wanes, reconcentrate their lobbying efforts to gain the upper hand against countervailing diffuse interests. We close by proposing potential solutions to conflicts of interest.
Conflicts of Interest and the Case of Auditor Independence:

Moral Seduction and Strategic Issue Cycling

People rely extensively on the advice of experts. Often, these experts face conflicts of interest between their professional obligation to provide good advice and their own self-interest. Conflicts of interest have played a central role in the corporate scandals that shook America at the turn of the 21st century. Many companies have joined Enron and WorldCom in issuing earnings restatements as a result of inaccuracies in published financial reports. Adelphia, Bristol-Myers Squibb, FastTrack Savings & Loans, Rocky Mountain Electric, Mirant Energy, Global Crossing, Halliburton, Qwest, AOL Time Warner, Tyco, and Xerox are some of the firms that have come under scrutiny for potentially corrupt management and a clear lack of independent financial monitoring. At the root of both this mismanagement and the failure of monitoring systems lie conflicts of interest. For example, stock options give upper management incentives to boost short-term stock prices at the expense of a company’s long-term viability. And auditors charged with independently reviewing a firm’s financial reports have often been found to be complicit with firm management in this effort. Accounting firms have incentives to avoid giving “bad news” to the managers who hire them and pay their auditing fees, not to mention their highly profitable consulting fees.

At large investment banks, research departments have become intertwined with sales departments; stock analysts seeking new business have recommended the stocks of current or potential clients to others. Happy clients boost the investment bank’s business, but members of the public who heed the analysts’ recommendations may not be as well served. The public receives lots of “Strong Buy” recommendations from analysts, a trend that increases short-term
stock value at the expense of long-term investment safety (Cowen, Groysberg, & Healy, 2004). Indeed, a survey cited by the SEC showed that in 2000, a period during which the stock market was in broad decline (the Dow Jones Industrial Average dropped 6 percent, the Standard & Poor's 500 index dropped 10 percent, and the NASDAQ dropped 41 percent), 99 percent of brokerage analysts’ recommendations to their clients remained “Strong Buy,” “Buy,” or “Hold” (Unger, 2001).

Physicians are charged with looking out for the best interest of their patients, a goal compromised by the common practice of doctors giving referrals to clinics and pharmacies in which they have ownership. In addition, biomedical and pharmaceutical manufacturers court physicians with free product samples, free meals, and free travel in an attempt to influence which drugs they prescribe. Doctors are typically loath to admit that such conflicts of interest affect their judgment. Yet their very livelihoods depend upon another conflict of interest: Physicians are in the business of prescribing services that they themselves will perform. We will argue both that doctors' advice is biased by these conflicts of interest and that doctors typically believe their biased advice is unbiased.

Politicians elected to represent the interests of their constituents have been accused of being swayed by private interests such as personal ties, soft-money donations to political campaigns, and other factors that can taint their decisions. Special-interest groups pre-select and even fund “independent” research to be made public at political gatherings and public conferences. Lobbyists seeking favorable legislation bend politicians’ ears, and corporations fill their campaign coffers.¹

One could take the optimistic position that these conflicts of interest in the American corporate, medical, and political realm are for the most part innocuous, or that they often work to
the clients’ benefit. After all, those most likely to have vested interests are also most likely to possess the most relevant expertise in a given field (Stark, in press). For example, many both inside and outside the accounting industry have argued that an auditing firm is better equipped to handle a client’s complex accounting tasks when the auditor also has deep consulting ties to that client. Similarly, a stock analyst might argue, “I would not recommend buying a stock that I myself did not own,” and proponents of stock options might assert that giving managers stock options in their company ensures that these employees are financially tied to the fate of their firm. In addition, some experts believe that conflicts of interest are innocuous because, on the whole, professionals who face them (in medicine, law, real estate, and accounting, and so on) maintain high ethical standards. According to this argument, aside from the occasional “bad apple,” we can expect the great majority of doctors, politicians, CEOs, accountants, and Supreme Court Justices to successfully navigate their conflicts of interest in an honest, unbiased, and non-corrupt way. However, both recent events and recent research have given us reason to question these assumptions.

Our own position can be stated simply. On the one hand, we recognize that conflicts of interest are pervasive features of life within all complex societies and that it would be prohibitively costly to try to reduce such conflicts to zero. On the other hand, we do not adopt a laissez-faire stance toward conflicts of interest. We believe that many conflicts of interest are far from innocuous, and indeed that abundant evidence exists that many of them have become truly egregious.

We offer two principal arguments, each of which presents a set of novel and testable theoretical propositions. The first argument is that the internal dynamics of “moral seduction” within professions encourages complacency among practitioners, as illustrated by the common
assertion that “we aren’t doing anything wrong.” We offer a detailed analysis of the cognitive, organizational and political forces that recently have so severely eroded auditor independence. Although it is tempting to be cynical about motivation, and to assume that professionals always realize when they are succumbing to conflicts of interest, we suggest this judgment is too harsh. Putting the most Machiavellian fringes of professional communities to the side, we suggest that the majority of professionals are unaware of the gradual accumulation of pressures on them to slant their conclusions, a process we characterize as moral seduction. Most professionals feel that their conclusions are justified and that they are being unfairly maligned by ignorant or demagogic outsiders who raise concerns about conflicts of interest. Given what we now know generally about motivated reasoning and self-serving biases in human cognition, and specifically about the incentive and accountability matrix within which auditors work, we should view personal testimonials of auditor independence with skepticism.

Our second argument has a more macro theoretical agenda: we seek to illuminate why society permits so many conflicts of interest to persist despite their corrosive effect on professional advice, decision making, and the allocation of societal resources. Specifically, we argue that the external dynamics of issue cycles in the political world can deflect many regulatory and legal demands for accountability that could check conflicts of interest before they spiral out of control. We argue that organization theory could benefit from an infusion of insights from the vast political-science literature on interest-group lobbying (supplemented by insights from the psychological literature on biases and errors in judgment and decision making). Organization theory, we believe, has placed too much emphasis on how organizations adapt to the diverse accountability demands impinging on them from the external environment (e.g., regulators, customers, courts, shareholders, and the media). A more balanced assessment would
recognize that organizations can be politically proactive as well as reactive, norm creators as
well as norm followers. We propose a political-psychological framework, “issue-cycle theory,”
that accounts for four recurring patterns in the real world: (1) many organizations aggressively
and successfully promote legislative and regulatory changes that work to their advantage; (2)
these organizations manage to create sufficient attributional ambiguity about their rent-seeking
behavior and thus stay below the radar screens of potentially countervailing interest groups; (3)
some of these organizations over-reach in these efforts and end up inflicting tangible losses (not
just opportunity costs) on well-defined, influential constituencies, thus becoming the targets of
political backlash; and (4) organizations often recover surprisingly quickly after outrage fades
and reconcentrate their lobbying efforts against the diffuse sources of countervailing power.

Before presenting our two core arguments in detail, we develop our case by examining
the role and history of auditing in the United States. Together, our arguments suggest a
pessimistic prognosis for would-be reformers. However, the situation is not hopeless. We
conclude on an optimistic note, offering remedial recommendations specific to auditing and
building on this case to offer advice on the broader topic of conflict of interest.

THE ROLE AND HISTORY OF AUDITING IN THE UNITED STATES

The efficiency of capital markets depends on the availability of reliable information about
the condition of the firms whose stock is publicly traded. Therefore, U.S. law requires that all
publicly traded firms submit to audits of their financial reports, performed by independent
outside auditors hired at the firm’s expense. Independence requires that these audits be carried
out without bias or subjectivity. Auditors are charged with either confirming that their clients’
public financial reports have been prepared in accordance with Generally Accepted Accounting
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Principles (GAAP) or issuing an opinion stating otherwise. According to the American Institute of Certified Public Accountants (AICPA) Council, “Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession’s strength and its stature” (Carey, 1970, p. 182). Simply stated, auditors are required to be independent from and unbiased by their clients’ interests. As former Chief Justice Warren Burger wrote on behalf of a unanimous U.S. Supreme Court (1984):

> By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This “public watchdog” function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

Despite this tradition, auditor independence has remained an elusive promise in the United States. While public officials and academics devoted some attention to failures of auditor independence prior to Enron’s bankruptcy, the public’s trust in financial institutions was shaken only after the fall of Enron and its auditor, Arthur Andersen. Andersen’s audit of Enron may have been the most notable failure of auditor independence, but it was by no means the first, the largest, or the last. The earnings restatement that precipitated Enron’s fall revised the company’s profits downward by $650 million. Yet prior to the Enron scandal, Waste Management Inc. overstated earnings by $1.43 billion over a five-year period, and U.S. regulators found that the company’s auditor, Arthur Andersen, conspired to hide accurate accounting data from the public. Since Enron’s fall, WorldCom, another Andersen client, revised its profit reports downward by a
shocking $9 billion. Cases of audit fraud were not limited to Arthur Andersen. PriceWaterhouseCoopers was forced to settle charges of fraud in connection with its audit of Tyco, a firm that has suffered a long string of accounting scandals. In all of these cases, auditors clearly failed to correct or expose serious inaccuracies in their clients’ financial reports.

These cases are only the most vivid of the multitude of cases in which the major auditing firms paid to settle lawsuits or lost cases in the courts, partially as a result of failures of auditor independence (Bazerman, Loewenstein, & Moore, 2002; Bazerman, Morgan, & Loewenstein, 1997). There is no shortage of speculation about the root cause of the many well-publicized accounting scandals. Some theories attribute them to changes in institutional arrangements, such as the increased use of stock options to compensate top managers, which created new incentives for showing ever-growing company earnings. Others point to a shift in corporate ethics from a focus on what is morally right to a focus on what is technically legal (Moore & Loewenstein, 2004). While corporate managers may attempt to manipulate earnings or reports to make them look as good as possible, the consequences would have been minor if these companies’ books had been subject to the kind of careful independent scrutiny that the U.S. auditing system is supposed to provide.

Outside auditors are hired to provide an independent, external opinion that can certify the truthfulness of a firm's own financial reports. Independence is the only justification for the existence of accounting firms that provide outside audits. If it were not for the claim of independence, there would be no reason for outside auditors to exist, as their function would be redundant with those of a firm's inside auditors. The assurance of independence is crucial to all of those who rely on audited financial statements for reliable information regarding a firm’s financial health, including investors, lenders, employees, and strategic partners. Although a
corporation’s managers often have powerful incentives to make their performance appear better than it is by improving reported earnings, outside auditors are supposed to help immunize the company’s financial reports from the threats posed by such incentives. Shareholders count on auditors to provide these independent reviews. Yet, for independence to exist, auditors’ reports must not be affected by any goal other than accuracy.

A Brief History of Audit Regulation

Prior to the stock market crash of 1929, there was relatively little regulation of the securities markets in the United States. The crash and the depression that followed caused public confidence in financial markets to falter. To restore faith in capital markets, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. These laws established what we now recognize as the Securities and Exchange Commission (SEC), required publicly traded firms to file financial reports with the SEC, and required that these reports be reviewed by independent outside auditors. Despite the SEC’s mandate to set accounting standards, it has generally relied on the accounting industry to set such standards.

Over the decades, the definition of auditor independence has evolved along with the accounting profession itself. In the 1920s and 1930s, the concept of independence was considered of great importance, and was focused on eliminating conflicts of interest that arose from financial relationships between auditors and their clients. Over the following decades, the appearance of auditor independence has become more important. Indeed, many in the accounting community argue that the primary value of hiring independent auditors is to reassure current and potential investors regarding a company’s financial well being (Antle, 1984; Dopuch, King, & Schwartz, 2001). As early as 1932, the AICPA Council noted the need to ensure that the appearance of objectivity exists, apart from actual independence in fact (POB Panel on Audit
Effectiveness Reports and Recommendations, 2002). More recently, the SEC released an appearance-based standard governing auditor independence, stating that “an auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment” (SEC Standard Release, 2000).

Given this history, it may not be surprising that the profession’s response to many accounting- and audit-related crises has focused on cosmetic changes that improve the appearance of independence. Independence in appearance but not in fact has tended to increase the so-called “expectations gap” between (1) the expectation that companies with upbeat financial reports and “clean” audit opinions are free of the risk of short-term business failure and (2) the reality of sudden collapse among firms whose reports make them look healthy.³ Baker (1993), Fogarty, Heian, and Owen (1991), and Lee (1995) have noted that the U.S. accounting profession in the 1980s responded by setting up new committees to review the problem and by intensifying peer review. However, solutions that could have improved independence in fact, such as the setting of more tangible standards, the threat of disciplinary action, and the development of new audit procedures, were not pursued (Fogarty et al., 1991; Reiter & Williams, 2000).

In June 2000 the SEC drafted a strong proposal designed to improve auditor independence in fact. The SEC proposal explicitly spelled out limitations on financial and personal relationships between the employees of auditing firms and their audit clients, and enumerated a list of banned non-audit services, including financial system design and implementation and internal audit outsourcing. The major accounting firms lobbied hard against the proposed limitations on their consulting work and dramatically increased their political
contributions to the major political parties (Mayer, 2002). Shortly thereafter, members of Congress pressured the SEC and its chairman, Arthur Levitt, to implement much weaker reforms than those initially sought (Levitt & Dwyer, 2002). The resulting compromise allowed auditors to continue offering consulting services, but required firms to disclose how much they paid their auditors for both audit and non-audit services.

This new rule did not prevent the financial scandals at Enron and WorldCom, which created enough public outrage that Congress passed the Sarbanes-Oxley Act of 2002. The Act includes a number of stipulations designed to increase auditor independence, but these changes concern appearance more than fact. For example, many have endorsed the Act’s stipulation that auditors rotate assignments every five years. Yet the Act in fact only requires the rotation of the lead audit partner, not the audit firm itself. Press reports also highlighted the Act’s ban on the provision of non-audit services, but typically ignored two facts: (1) the ban omits important services, such as tax services; and (2) Provision 201b of the Act allows the new Public Company Accounting Oversight Board to “exempt any person, issuer, public accounting firm, or transaction from the prohibitions on the provision of services…” on a case-by-case basis. Furthermore, while the Act prohibits employees of audited firms from being hired by their auditors, this prohibition applies only to those who served as CEO, CFO, controller, or chief accounting officer at the client firm, and only limits them from auditing their former employers for one year. The Act does nothing to limit the hiring of auditors by client firms, which is far more common than the reverse. In other words, while the Act appears to address important issues surrounding auditor independence, it is insufficient to create true auditor independence. In legislation, the proverbial devil lurks in the details—details that special interests can often
successfully influence as long as politicians project the image of decisive action to the broader public.

THE MORAL SEDUCTION OF THE ACCOUNTING PROFESSION

The United States, like many nations, has institutionalized a set of regulatory structures for governing auditing that create an environment in which auditor independence is virtually impossible. This section of the paper first describes these structures, then delineates the impact they can be predicted to have on auditor judgment.

Structural Threats to Reducing Conflicts of Interest

We define structural threats to reducing conflicts of interests as those features that describe how an industry or relationship between a service provider and its clients is organized. We argue that the current auditing system institutionalizes at least three potential threats to independence: managers hiring and firing auditors, auditors taking positions with clients, and auditors providing non-audit services.

Who hires and fires the auditors? Clients, who have the freedom to choose their auditors, have many reasons to select an auditing firm based on the likelihood that the auditor will deliver an affirmative audit opinion. The fact that the probability of a client switching auditors increases following a critical audit report is likely to reduce the auditor’s desire to file such a report (Levinthal & Fichman, 1988; Seabright, Levinthal, & Fichman, 1992). One practice that auditors might use to signal their willingness to accommodate the client’s wishes is known as “low-balling”: offering a discounted price for audit services in order to build a relationship that could become profitable later, either by increasing audit fees or by cross-selling
services. There is some evidence that low-balling increases auditors' willingness to acquiesce to the client's desires (Beeler & Hunton, 2003; but see also DeAngelo, 1981a; Lee & Gu, 1998).

Some researchers have posited that the size of the audit firm would affect the degree to which they fear being fired. DeAngelo (1981a) and Simunic (1984) argue that larger audit firms ought to be more resistant to client pressure to manipulate reported earnings, and Eichenseher (1984) and Palmrose (1986) have suggested that “brand-name” auditors are at least perceived to be more independent. However, research in this area has been inconclusive. Pany and Reckers (1980) and McKinley, Pany, and Reckers (1985) failed to find an effect of audit firm size. Even if the audit firm itself does not depend on any specific client for its survival, the careers of particular audit partners depend a great deal on their success with individual accounts. Overall, however, we only have indirect evidence of whether hiring and firing decisions negatively influence audit quality (for a more thorough review of this literature, see M. Nelson, in press).

**Auditors taking jobs with clients.** Auditors’ independence from their clients is compromised by any relationship that builds a common identity between the two. Psychological research on the “minimal group paradigm” has demonstrated how easy it is to establish a group identity that leads people to favor fellow in-group members (Tajfel & Turner, 1986). Thompson (1995) has shown that even the most superficial affiliation with a partisan leads people to interpret ambiguous information in ways that are consistent with the partisan’s interests. Indeed, several studies have found that auditor independence and the quality of auditing decisions deteriorate over time as the auditor-client relationship lengthens (Beck, Frecka, & Solomon, 1988; Dies & Giroux, 1992; Mautz & Sharaf, 1961). In addition, there can hardly be a more effective means of establishing a common identity between auditor and client than rotating personnel between the two. This was the case in Andersen’s relationship with Enron, as it is
with other accounting firms and their clients. Obviously, independence is compromised when an auditor hopes to develop job opportunities with the audited firm. The minimal restrictions on personnel rotation established by the Sarbanes-Oxley Act are clearly insufficient, given the high frequency with which auditors at all levels take jobs with audit clients.

**Non-audit services.** Much of the debate surrounding auditor independence has focused on the provision of non-audit services, also known as management advisory services (MAS), by audit firms to their audit clients. In 1978, the SEC required companies to disclose any non-audit services their auditors performed for them if and when the fees paid to the auditor for non-audit services were at least 3 percent of the audit fees paid. However, this requirement was repealed in 1982. The SEC concluded that the required disclosure “was not generally of sufficient utility to investors to justify continuation” (Securities and Exchange Commission, 1982), despite evidence showing that knowledge of a consulting relationship creates a perceived lack of auditor independence (Farmer, Rittenberg, & Trompeter, 1987; Gul, 1991; Knapp, 1985; Pany & Reckers, 1983; Shockley, 1981; Turpen, 1995).

Non-audit services proved to be an important growth area for accounting firms. By 1999, fees for non-audit services grew to 66 percent of revenues and 70 percent of profits for the major accounting firms (POB Panel on Audit Effectiveness Reports and Recommendations, 2002). Some evidence has suggested that high consulting fees have indeed biased auditors’ judgment (Frankel, Johnson, & K. Nelson, 2002; Ruddock, Sherwood, & Taylor, 2004; Kinney, Palmrose, & Schulz, 2004). However, these conclusions are controversial (Chung and Kallapur, 2003; Larcker and Richardson, 2004; Ashbaugh, LaFond, and Mayhew, 2003; Antle, Gordon, Narayanamoorty, & Zhou, 2002; Butler, Leone, & Willenborg, 2002; Craswel, Stokes, &
Laughton, 2002). In any case, the Sarbanes-Oxley Act has made it more difficult for an accounting firm to provide consulting and auditing services to the same client at the same time.

**Cognitive Threats to Reducing Conflicts of Interest**

We define cognitive threats to reducing conflicts of interests as characteristics of the human mind that lead actors and observers to accept conflicts of interests in the organization of an industry or in the relationship between service provider and clients. These cognitive factors can also help explain why citizens accept policies that allow conflicts of interest to persist. The field of accounting, and public policy in the United States more broadly, has been dominated by an economic lens of analysis (Ferraro, Pfeffer, & Sutton, in press). Consistent with this economic approach, models of auditor independence have assumed that independence is a question of whether the auditor chooses to carry out a thorough, unbiased audit or collude with a firm’s managers (Antle, 1984; DeAngelo, 1981b; Simunic, 1984). Psychological research on the impact of motivated reasoning and self-serving biases questions the validity of this assumption. This evidence suggests that intentional corruption is probably the exception, and that unconscious bias is far more pervasive. This distinction between conscious corruption and unconscious bias is important because the two respond to different incentives and operate in different ways.

**Selective perception.** Evidence on unconscious bias suggests that people are not very good at disregarding their own self-interest and evaluating information impartially, even when they try to do so. When choosing how to allocate scarce resources, people honestly believe that they deserve more than independent observers think they deserve (Messick & Sentis, 1979). People justify self-serving decisions by referencing whatever arguments favor them (Diekmann, 1997; Diekmann, Samuels, Ross, & Bazerman, 1997; Messick & Sentis, 1983), without
awareness of this selective perception. Ignorance of these self-serving biases can have important consequences for economic decisions (Babcock & Loewenstein, 1997; Thompson & Loewenstein, 1992).

People appear to evaluate evidence in a selective fashion when they have a stake in reaching a particular conclusion. They focus on evidence supportive of the conclusion they would like to reach (Holyoak & Simon, 1999; Koehler, 1991; Lord, Ross, & Lepper, 1979; Russo, Medvec, & Meloy, 1996; Russo, Meloy, & Medvec, 1998; see Rabin & Schrag, 1999 for a theoretical model). When they cannot ignore conflicting evidence, they often subject it to additional critical scrutiny (Gilovich, 1991). This tendency toward biased information processing prevails even when people on different sides of an issue are exposed to the same information (Babcock, Loewenstein, Issacharoff, & Camerer, 1995). While some observers have suggested that professional auditors might be less affected by these biases, research has found professionals to be vulnerable to the same motivated biases as are laypeople (Buchman, Tetlock, & Reed, 1996; Cuccia, Hackenbrack, & Nelson, 1995). Once auditors learn and encode information from a partisan perspective, they are no longer able to objectively assess the data, and view ambiguous data consistent with the preference of their clients (Babcock et al., 1995; Messick et al., 1979; Thompson & Loewenstein, 1992).

**Plausible deniability.** When it comes to biased judgments, evidence suggests that people are more willing to endorse a biased proposal made by someone else than they are willing to make on their own. Diekmann, Samuels, Ross, and Bazerman (1997) showed that people tend to be somewhat more cautious about indulging their biased preferences when they are asked to make their own independent proposals than when they are asked only to approve or reject a proposal made by someone else. The current system, in which auditors are charged only with
assessing whether or not the client's reports comply with Generally Accepted Accounting Principles, is likely to exploit the tendency to “go along” with the actions of another even when that action raises some questions or concerns.

**Escalation of commitment.** Another important bias specifically relevant to the realm of conflict of interest is the tendency of people to escalate their commitment to a previous course of action (Straw, 1976; Brockner and Rubin, 1985). One question that has repeatedly been asked since the collapse of Enron is how Arthur Andersen ever signed off on Enron’s accounting procedures. Our hypothesis is that, at least in part, corruption occurs one step at a time. For example, in one year, an auditor might decline to demand the client change an accounting practice that is at the edge of permissibility. The next year, the auditor may feel the need to justify the previous year’s decision and may turn a blind eye when the client pushes just past the edge of permissibility. The next year, the auditor might endorse accounting that clearly violates GAAP in order to avoid admitting the errors of the past two years, in the hope that the client will fix the problem before the next year’s audit. By the fourth year, the auditor and client are both actively engaged in a cover-up to hide their past practices.

More broadly, we imagine that many behaviors in the realm of conflicts of interest begin as minor questionable calls that sometimes escalate into violations of ethical standards and the law. We expect that escalation in the acceptance of unethical behavior will be especially pronounced to the degree that acting ethically would require one to disappoint those with whom one works every day and accept immediate punishment (loss of income and social status, and perhaps legal penalties). By contrast, the unethical path would require one to live with a difficult-to-gauge probability of eventual disclosure and humiliation some time in the indefinite future.
Some have argued that accounting firms have a real interest in reporting a breach of accounting if it exists, given the real threats of legal penalties and shareholder lawsuits. This interest should lead accounting firms to establish systems that could counteract the threats to independence posed by the issues described above. While it is clearly true that accounting firms do have an interest in preserving their reputations and avoiding legal charges of fraud, it is entirely unclear whether these distant and probabilistic threats are sufficient to counteract real and immediate incentives to build relationships with clients and sell them services, especially given recent reductions in the threat of legal penalties. Furthermore, even if accounting firms have an interest in creating unbiased reports, individual auditors, whose careers may depend on building relationships with their clients, and who may even be interested in working for those clients, face very different incentives.

**Inaccuracies in self-perception.** Conflict of interest increases as financial incentives and professional obligations clash. The greater the incentives created for professionals to act against their obligations to society or to their clients, the greater the expected deviation from professionally defined normative behavior. These incentives are likely to lead professionals both to increase their defense of the ethical rectitude of their profession and to resist changes that could actually resolve the conflict of interest.

Conflicts of interest hinder people from making objective assessments, yet professionals often deny that their decisions are biased by conflicts of interest. In medicine, ample evidence documents the biasing influence of gifts from and sponsorship by pharmaceutical companies (Bower & Burkett, 1987; Caudill, Johnson, Rich, & McKinney, 1996; Dana & Loewenstein, 2003; Wazana, 2000), yet physicians strenuously deny that their clinical judgment is compromised by such blandishments (Hume, 1990). Accountants also deny corruption. In his
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testimony before the SEC, Gary Shamis, then chairman of the Management of an Accounting Practice Committee of the AICPA, stated, "We take the existing independence rules quite seriously, and consequently abide by all the existing rules. We are professionals that follow our code of ethics and practice by the highest moral standards. We would never be influenced by our own personal financial well being" (Shamis, 2000). Although such sentiments are noble, they do not constitute strong evidence for lack of bias.

**Effects of accountability.** The literature on accountability predicts that the types of accountability pressures operating on professionals in conflict-of-interest environments should exacerbate rather than attenuate the motivated reasoning underlying moral seduction. The principal accountability pressure at work is to justify one’s professional practices to powerful, opinionated audiences with well-defined views—namely, one's clients and one's superiors. In a pre-decisional setting, these accountability demands encourage strategic attitude shifting (which need not be conscious; Cialdini, Petty, & Cacioppo, 1981) and the selective generation of reasons to justify going along with dominant-audience expectations (Tetlock, 1983, 1992). In a post-decisional setting, these types of accountability demands encourage post-decisional bolstering and the selective generation of reasons to justify what one has already done (Straw, 1976; Tetlock & Lerner, 1999).

The literature on debiasing judgment strongly suggests that there is no silver-bullet accountability solution for ensuring that auditing professionals do not engage in the types of motivated reasoning underlying moral seduction. Ironically, the accountability literature suggests that the best solution to the corrupting effects of conflicts of interest may well be to create countervailing conflicts of interest that compel practitioners to become painfully self-conscious and preemptively self-critical about their auditing practices. Defenders of the status
quo might argue that the courts already serve this role. But this type of formal legal accountability is highly uncertain, activated only in the most egregious cases, and generally has been far removed in time and far less salient than immediate accountability pressures from clients who prefer self-serving solutions to auditing problems and from partners within the accounting firm who prefer to maximize billing hours. To be effective, accountability for the implementation of high professional standards must come much more rapidly and much more directly from within the firm—as, in principle, existed within Arthur Andersen through its Professional Standards Group. However, the recommendations of the Professional Standards Group regarding the Enron account were overruled at the highest levels of the firm (McRoberts, 2002). There is a critical need for regulatory and legal protection of internal professional-standards groups that enforce the types of accountability shown in the laboratory literature to encourage complex and self-critical forms of reasoning (e.g., accountability to audiences whose expertise is esteemed, whose respect is needed, and whose own views cannot be easily inferred; Tetlock & Lerner, 1999).

*The search for a smoking gun.* Too many reform efforts have fallen victim to the human tendency to focus on simple causes for complex problems (McGill, 1989). In their 2000 hearings, SEC commissioners searched for the proverbial “smoking gun” that would prove bias on the part of identifiable auditor culprits. The commissioners were looking for an email or memo that would provide clear evidence of knowing and intentional corruption. Lobbyists for the accounting industry and CEOs from Big Five accounting firms noted that there was no evidence of a single audit being tainted as a result of the auditing-consulting relationship. Although such evidence may sometimes emerge (as it did in the Waste Management case), proving that a particular case of audit fraud was caused by the presence of non-audit services is
nearly as difficult as proving that any particular smoker’s lung cancer is due to smoking; each case is complicated by numerous confounding factors. More importantly, this standard of proof falsely assumes that the most common threat to auditor independence is intentionally corrupt behavior. If the real threat is unconscious bias, auditors may never make a “smoking gun” statement that reveals corrupt intent. If this is true, we need to change the system, not simply lock up the guilty parties.

The institutionalization of a search within the legal system for corrupt actors is broadly consistent with the psychological tendency to attribute behavior to individual dispositions, talents, or failings, rather than to situational constraints or opportunities (Jones & Harris, 1967; Ross & Nisbett, 1991). This judgmental error leads people to attribute the cause of an event or problem to an individual, rather than to the broader situation or context (see Morris & P.C. Moore, 2000). Thus, even when the flaw exists within the system, we too often seek a corrupt person to punish, rather than examining the flaws in the system or fighting against those who lobby to keep the broken system in place. Thus, legislative barriers to resolving conflicts of interest are partly rooted in cognitive barriers.

From the standpoint of moral-seduction theory, one does not need to be Machiavellian or sociopathic to succumb to conflicts of interest. Indeed, psychological evidence suggests that the overwhelming majority of human beings, placed in such circumstances, would respond in roughly the same fashion. Although many observers are surprised and depressed that so few whistle-blowers protest moral lapses, the psychological literature tells us to appreciate when any individuals come forward at all.
WHY ARE CONFLICTS OF INTEREST SO PERVERSIVE?

Through its minimal oversight of the auditing profession, the United States legislative system allowed conflicts of interest to become pervasive in the industry. The history of the accounting profession in the 20th and now early 21st century fits a cyclical pattern in political issues that has been well documented by political scientists who study the lobbying efforts of special interests (such as accountants, CEOs, medical doctors) to seek regulatory and legal advantages for their members. These advantages can occasionally become so flagrant that they attract public attention. The resulting scandals trigger countervailing political influence and widespread condemnation of the excesses of private action, causing at least temporary setbacks for the special interests. Once the outrage wanes, the special interests once again take the political offensive, poking low-visibility loopholes in the high-visibility legislation (e.g., Sarbanes-Oxley Act) that politicians point to as evidence of their responsiveness to the public’s concerns.

This issue-cycle analysis draws on two key strands of political theory. On the one hand, interest-group-stasis theory posits an inevitable trend in which well-connected interests gain control over government policies on a piecemeal basis, each group controlling policies in its own area of activity. Over time, this produces the political-economic equivalent of arteriosclerosis (sometimes called “demosclerosis”; Rauch, 1995). Stasis theory posits the trend to be inevitable because it is individually rational; because it would not benefit any individual to incur the time and money costs of organizing the group, widely shared interests, such as the desire for true auditor independence or a loophole-free tax system, will founder (Olson, 1965, 1980; Lowi, 1965). Symbolic political commitments can overcome this powerful inertial lag for only brief
periods of time, usually through bouts of outrage. Smaller concentrated groups thus have an inherent advantage over larger diffuse ones for the simple reason they are less subject to the free rider problem.

Some stasis theorists also add that very diffuse and unorganized publics are particularly prone to irrational perceptions of political reality. Such publics confuse symbol with substance, making it easy to manipulate mass opinion by creating political forms that give the impression that a problem is being solved or a policy is being pursued when this is not the case. For example, many observers have noted the political advantages that accrue from the confusion over the “Healthy Forests Initiative” (the Healthy Forests Restoration Act of 2003), a law that opens up significant new areas to logging and deforestation by private interests. While 70 percent of the American public identifies themselves as environmentalists (National Environmental Survey, 1998), this large and inchoate group is less likely to appreciate the regulatory niceties of forest regulation than are the logging companies themselves. Political groups consisting of a well-defined sector of business do not usually confuse symbol with substance. Such small groups, following organized political strategies, will frequently prevail over the interests of very large publics confused by political symbols and strategies. The combination of intelligence and money is hard to beat.

Of course, stasis theory explains only the build-up-to-scandal phase of the issue cycle. Countervailing-power theorists, such as Wilson (1980) and Walker (1983), have noted that the pattern of interest-group organization is often complex, with many groups effectively organized to influence policy in particular arenas. The complex pattern of group organization means that other groups often exercise countervailing power to the special-interest group that might otherwise dominate an area of policy (Becker, 1983). Building on this work, and on behavioral-
economic theories of fairness that posit the willingness of observers to incur additional losses to punish cheaters (Fehr & Gächter, 2000), we hypothesize that countervailing power is most likely to be mobilized when coalitions of adversely affected group members perceive that particular concentrated interests have gone too far, “pigging out” and inflicting real losses (beyond opportunity costs) on the members of the larger group.

While clearly in tension with each other, stasis and countervailing-power theories are not mutually exclusive. It is perfectly possible that interest-group stasis is a widespread background condition of political and economic life but that concentrated interest groups often overreach, producing the backlash effects described by countervailing-power theorists. This dynamic goes a long way toward explaining the ambivalence of the American public toward interest-group politics. Most Americans recognize that interest-group actions (especially those of their own interest groups, which they tend to identify as professional associations or community action) are indispensable for the functioning of a modern democracy. But they also distrust interest groups (especially those of others), fearing that groups will abuse their legitimate power (Schlozman, 1984).

To our issue-cycle approach, we add that the success of interest groups in pursuing their private ends without activating countervailing power is a function of both how careful they are to avoid pushing their agenda too aggressively and how skillfully they mask rent-seeking in the rhetoric of the public good. Accountants did not declare that they wanted to be free to make as much money as possible by offering as wide a range of services as possible. Rather, they cloaked their claims in the ideology of the free market and economic efficiency, as in a now-famous letter from Kenneth Lay, then chairman of Enron, to Arthur Levitt, then chairman of the SEC, explaining why Andersen should be allowed to continue offering both auditing and consulting
services to Enron. This letter, which was authored not by Lay but by Andersen’s lead audit partner at Enron, David Duncan, claimed that Andersen’s expanded role was, “valuable to the investing public, particularly given the risks and complexities of Enron's business and the extremely dynamic business environment in which Enron and others now operate” (Lay, 2000).

Just as one person’s freedom fighter is another’s terrorist, so one observer’s venal special interest is another’s legitimate professional association exercising its voice in a democracy (Tetlock & Mitchell, 1993). However, issue-cycle theory stipulates that attributional ambiguity—uncertainty about the underlying motives of other players—is a matter of degree. The willingness of outsiders—potential sources of countervailing power—to give credence to the rhetorical posturing of one’s interest group will decline in relation to the magnitude of the perceived losses that one’s interest group is inflicting on outsiders. Kenneth Lay’s letter once packed considerable political clout; today, it is a painful reminder of past excesses.

Thus, issue-cycle theory suggests a definition of prudent long-term political advocacy for interest groups: Good advocates know where they are in the issue cycle. They capitalize on opportunities to push hard for regulatory advantages in benign environments where they can fly below the radar screens of potential adversaries. Good advocates also know when it will be difficult to hide under rhetorical smokescreens and when to back off before triggering scandal and backlash.

Finally, when thinking about the dynamics of issue cycles, it is critical to consider the political-psychological nature of the most common target for special interest influence: our legislative system. Legislators are not philosopher-kings who seek ideal solutions to problems such as auditor independence or sugar price supports (Wildavsky, 1988). Rather, they typically ask what adjustments, if any, should be made to the status quo (Baron, 1996; Bazerman, Baron,
& Shonk, 2001), making the existing system an anchor for future policy (Samuelson & Zeckhauser, 1988). Solving conflicts of interest requires significant changes to government policy. Thus, when contemplating a change, Baron (1998) argues that people are more likely to be concerned about the risk of change than about the risk of failing to change, and therefore will be motivated to preserve current systems and beliefs. The status-quo bias makes us reluctant to eliminate important conflicts of interest when their elimination would impose small costs on specific, and likely vocal, members of society. Those with a vested interest in the status quo (such as the major accounting firms and investment banks) are typically more willing to invest resources to maintain the status quo than the forces for reform can expend on inducing change. Overwhelming evidence is often necessary to build up the necessary political momentum to change legislation. Rather than asking what the best system would look like, legislators ask whether public pressure warrants changes to the status quo. As legislators might say in their defense, politics is the art of the possible.

A second set of issues arises when we consider why we, as a society, fail to adequately address destructive conflicts of interest. In a sense, the failure of auditor independence is rooted in the failure to resolve politicians’ conflicts of interest between representing the voters and funding their political campaigns. In the presidential primaries of 2002, campaign finance reform finally caught the attention of the public when both Bill Bradley and John McCain made it an issue. Public outrage was fanned by publicity about wasteful and harmful subsidies, such as the U.S. government’s $83.5 million annual assistance to tobacco growers (Bazerman et al., 2001). How do special-interest-group politics and the failure of meaningful campaign finance reform play out in the U.S. auditing system?
When SEC Chairman Arthur Levitt considered significant reforms to the auditing system, he became the target of what he later called an “intensive and venal lobbying campaign” (Lobaton, 2002). The accounting industry convinced 46 members of Congress to call or write letters to Levitt questioning the proposed rule (Center for Responsive Politics, 2002). Most of the lawmakers argued that the accounting firms should be trusted. Some threatened to withdraw funding from the SEC and to conduct ethics reviews of the commissioners. Especially vociferous in their defense of the accounting industry were Rep. Billy Tauzin, who went on to oversee the House Energy and Commerce Committee’s investigation into Enron, and Rep. Dick Armey, the House majority leader.

In total, these 46 members received millions of dollars in campaign contributions from the Big Five accounting firms (Center for Responsive Politics, 2002). The major accounting firms and the AICPA, their trade association, contributed more than $38 million to the political process between 1989 and 2001 (see Table 1). In the face of this political pressure, Levitt backed down from his tough stance, although he later called his decision to back down the biggest mistake of his SEC tenure (Mayer, 2002). The Sarbanes-Oxley Act ultimately passed after public outrage created by the fall of Enron and other firms, accomplishing some of Levitt’s goals. While the current law introduces some important reforms, they are clearly insufficient, focusing on intentional corruption and overlooking the conflicts of interest built into the system.

While we do not deny that corrupt auditors exist, we argue that a focus on corruption neglects what is probably a far more important source of violations of auditor independence: unconscious, and hence unintentional, bias. This brings us to the point of reconciling the two tiers of our theory. At the macro level, we have depicted organizations as aggressively and strategically exploitative. Yet our micro-level explanation for the behavior of individuals
suggests far less avaricious intent; indeed, our review of the individual-level psychological evidence suggested that people strive to view themselves as fair and even-handed. We do not believe that these two views are, in fact, contradictory. It is precisely because individuals are so good at serving their own self-interest while persuading themselves that their actions are perfectly reasonable that firms and individuals can provide sensible explanations for their behavior exploitative behavior. The most effective lies are those we ourselves believe. Furthermore, even if most people are constrained from exploiting others for individual gain, the competitive forces at work on organizations may favor those groups which effectively seek their own gain, even if this means establishing routines and practices that circumvent or modify the more fair-minded motives of most of the organization’s members.

RESOLVING CONFLICTS OF INTEREST

Given the cognitive and political barriers to solving the problems created by conflict of interest, it is unlikely that society will ever entirely eliminate them. Nevertheless, that does not mean that it is impossible to limit their worst excesses. Here, we explore possible avenues for creating auditor independence. Congress, President George W. Bush, and the SEC have all put forth or passed measures aimed at making auditors more independent. But these policy changes have focused on increasing penalties for corruption and punishing corrupt individuals. While important first steps, research suggests that they are based on an incorrect understanding of the main source of auditor bias and therefore are inadequate solutions to a systemic problem. Mild reforms and the occasional legal penalty will not provide true auditor independence, and more corporations will fail as a result.
One popular response to the problems associated with conflicts of interest is full disclosure. But recent research suggests that disclosures cannot be assumed to protect consumers of biased information. Indeed, disclosure can sometimes even make matters worse; professionals may be more willing to give biased advice when they know that the person receiving the advice is aware of their conflict of interest (Cain, Loewenstein, & Moore, in press). Also, recipients of biased advice are likely to have difficulty using disclosures effectively. Evidence has shown that people are easily influenced by advice, even when they know that it has been designed to manipulate them and they consciously attempt to resist its influence (Strack & Mussweiler, 1997; Camerer, Loewenstein, & Weber, 1989).

We believe there are two possible means of fixing the U.S. auditing system. The first solution would leave the existing auditor-client relationship largely intact but increase its regulation in five important ways. First, we believe that auditors should perform audits and no other services. Second, we believe that an audit firm should be hired for a fixed period, perhaps five years. During this period, the client must not be able to fire the auditor, to reduce the auditor’s incentive to please the client with a positive opinion. Following this fixed period, the auditor assignment should rotate, not to another partner within the same firm (as is the case under the Sarbanes-Oxley Act), but to a different accounting firm. Third, all parties involved in the audit, executives and staff alike, should not be allowed to take jobs with the firms that they audit. Fourth, auditors should make a set of independent assessments, rather than simply ratifying the accounting of the client firm. Fifth, the auditor should be chosen not by company management, but by the audit committee of the board of directors. The decision of whom to hire to make an independent assessment of a firm’s finances should not reside with those whose work will be evaluated.
These five steps would add a great deal of governmental regulation to the auditor-client relationship. Enforcing these laws is likely to be costly and would not eliminate the basic problem created by accounting firms’ political influence. That is why we favor our second possible solution: a radical restructuring of the entire auditing industry. Ronen (2002) has proposed eliminating the legal requirement that publicly traded firms submit to regular audits of their financial reports. Instead, firms would be required to buy financial statement insurance to insure against the possibility of being sued for issuing inaccurate financial reports. In this system, the sellers of such insurance—the insurance companies—would hire the auditors.

We view these recommendations as a blueprint for thinking about how to solve conflict of interest problems in a general sense. To cure conflicts of interest, we need to study them, identify the structural changes needed to eliminate them, and think strategically about how to overcome the cognitive and political barriers to structural reforms. Conflict of interest is easily understood, yet mobilizing action to correct deeply rooted problems is difficult. Similarly, auditor independence is an easy concept to grasp, yet difficult to implement. In this paper, we have attempted to show that a corrupting system has been institutionalized across levels in one domain of conflict of interest—from the mind of the auditor to the structures that govern the industry, and from legislation to the political process that creates it. Investors, shareholders, and financial markets depend on independently audited corporate financial reports, yet the system has never provided true independence. Only through a radical reorganization of the industry will the term “auditor independence” accurately describe auditors’ work in the United States. Many may argue that such dramatic reforms may be costly. Yet doing nothing yields even greater risks; indeed, we may not be able to afford not to make these changes.
Clearly, there are multiple causes for the failure of auditor independence. The basic grounds rules of our political system have prevented necessary legislative reform; this faulty legislative system has institutionalized a corrupt set of structures; and these structures lead to biased decisions and occasionally outright corruption. Current laws have created an inefficient, unethical, and wasteful system. Stiglitz (1998) argues that wise government should strive to create near-Pareto efficient changes. With 280 million citizens in the United States, it is difficult to create changes that have no losers. However, in some cases there exist parties that have an unfair advantage due to their distortion of the political process. We believe that this is the case in the auditing system, and that the costs of creating true independence are worthwhile for the government, the financial markets, and for the vast majority of citizens. As is generally the case in problems of conflict of interest, only those audit firm partners and co-opted executives who have benefited from the corrupt system would lose in the creation of true auditor independence. Such conflicts are psychologically and politically intractable. In the case of the U.S. auditing system, basic structural reform is profoundly difficult to achieve, yet essential.
References


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Footnotes

1 Of course, conflicts of interest are not unique to the United States. The success of the U.S. free-market system, particularly in the late 1990s, inspired many nations to follow its policy lead. Leuz, Nanda, and Wysocki (2003) report that misleading accounting practices such as "earnings management" are at least as common abroad than they are in the United States. Across the globe, differing practices make conflicts of interest and their disclosure a particularly thorny issue for multinational corporations.

2 The “Final Four” major remaining accounting firms are KPMG, Deloitte & Touche, PriceWaterhouseCoopers, and Ernst & Young.

3 An auditor’s opinion can be classified into one of four types: a standard unqualified opinion (in other words, a “clean” opinion which states that the auditor agrees that the financial statements are presented fairly—which refers to a lack of misinformation—and in accordance with GAAP); an unqualified opinion with an explanatory paragraph or modified wording (which means that the audit was satisfactory, but that auditor believes the firm should provide additional information); a qualified opinion (in which the financial statements were fairly presented, but the scope of the audit has been materially limited or statements were not prepared in compliance with GAAP); and an adverse opinion (in which the auditor is unable to form an opinion as to whether the financial statements are fairly presented) or a disclaimer (which means that the auditor is not independent) (Arens et al., 2003).

4 The Securities Reform Act of 1995, passed with generous support from the accounting industry, changed the standard for assessing liabilities in securities fraud cases from joint and several to proportionate liability, thereby significantly reducing the liabilities faced by the accounting firms.
TABLE 1
Lobbying Expenditures of Accounting Firms During Calendar Years 1997-2003

<table>
<thead>
<tr>
<th>Year</th>
<th>Arthur Andersen</th>
<th>Deloitte &amp; Touche</th>
<th>Ernst &amp; Young</th>
<th>KPMG</th>
<th>Price-Waterhouse Coopers*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>$2,380,000</td>
<td>$ 785,000</td>
<td>$1,380,000</td>
<td>$ 600,000</td>
<td>$ 900,000</td>
</tr>
<tr>
<td>1998</td>
<td>1,985,000</td>
<td>360,000</td>
<td>1,420,000</td>
<td>420,000</td>
<td>960,000</td>
</tr>
<tr>
<td>1999</td>
<td>1,840,000</td>
<td>890,000</td>
<td>1,200,000</td>
<td>850,000</td>
<td>1,220,000</td>
</tr>
<tr>
<td>2000</td>
<td>2,480,000</td>
<td>2,524,000</td>
<td>1,200,000</td>
<td>1,340,000</td>
<td>1,425,000</td>
</tr>
<tr>
<td>2001</td>
<td>1,540,000</td>
<td>580,000</td>
<td>1,320,000</td>
<td>1,175,000</td>
<td>1,240,000</td>
</tr>
<tr>
<td>2002</td>
<td>-</td>
<td>1,027,455</td>
<td>2,343,860</td>
<td>1,430,000</td>
<td>3,160,000</td>
</tr>
<tr>
<td>2003</td>
<td>-</td>
<td>660,000</td>
<td>1,980,000</td>
<td>925,000</td>
<td>1,680,000</td>
</tr>
</tbody>
</table>

Data from the Office of Public Records, http://sopr.senate.gov
* The 1997 total is a combined total of Price Waterhouse and Coopers & Lybrand, which were then separate companies.